

## **Query No. 17**

**Subject:** *Accounting treatment for advance payment made towards way leave charges as a part of laying city gas distribution network.*<sup>1</sup>

### **A. Facts of the Case**

1. A Company (hereinafter referred to as ‘the Company’) limited by shares is domiciled in India and was incorporated on 23<sup>rd</sup> December 1998 under the erstwhile Companies Act, 1956. The Company is listed on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE).

2. The Company is in the business of city gas distribution. As a part of its operations for laying down city gas distribution network, the Company enters into way leave agreements with Indian Railways wherein way leave charges are charged by Indian Railways for allowing occasional or limited use of its land by a party for a specified purpose like passage, access to private houses and establishments, and laying underground pipelines.

3. The querist has stated that the Company has to enter into way leave agreements with Railways for 10 years by paying upfront payment with the following relevant terms (a copy of Memorandum Way Leave Agreement entered into by the Company has been separately provided by the querist for the perusal of the Committee):

- As per clause 4 of the Agreement, Agreement will be valid for a defined period of 10 years and the way leave charges are to be paid in advance in the form of capitalised amount;
- As per clause 5, the amounts are to be fixed in advance for a block of 5 years.
- As per clause 2, the Company as a grantee of way leave facility has been allowed to lay the pipeline across railway land on the sole cost of the Company; which shall be maintained, repaired and renewed by the Company;
- As per clause 3, the legal ownership of the railway land still remains with the grantor; but the Company has been permitted to use such land for laying its pipeline. The Company shall not transfer or sublet the privilege granted by the way leave facility and use the facility granted only for defined intended purpose.

4. The querist has stated that Ind AS Transition Facilitation Group (ITFG) vide bulletin No. 22 clarified (Oct 2019) about lease term (under Ind AS 116, ‘Leases’) of way leave charges paid by an entity X (lessee) to Railway (entity Y) for a period of 10 years. ITFG noted that as per contractual terms, X had no tenancy right or interest in land and some of principal terms of way leave agreement are detailed below:

- Either party shall be at liberty to terminate arrangement by one month prior notice;
- In case, Y gives notice, X shall remove at its own cost the facility (transmission line);
- Y reserves full rights to enter upon pass through or use the land;
- X shall not enter upon the railway land without previous consent of Y;
- X shall use the facility granted only for the purpose for which it has been granted;
- X shall execute the work as per plan approved by Y;
- X shall not transfer / sublet the way leave rights.

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<sup>1</sup> Opinion finalised by the Committee on 11.10.2022.

In the above case, ITFG opined that where a lease agreement is entered into for 12 months or less, it qualifies as a short term lease. If X concludes that termination option would not be exercised, the agreement term would be 10 years, and consequently, lease will be a long term lease since Y is government owned entity and termination of agreement is meant to be exercised only in exceptional circumstances as there is no economic incentive for entity Y to terminate lease.

Thus, according to the querist, it is inferred that ITFG has well appreciated principal terms of way leave agreement and considered the same as lease under Ind AS 116.

5. The querist has informed that before introduction of Indian Accounting Standard (Ind AS) 116, 'Leases', the Company used to classify these way leave charges as 'Prepaid Expenses' under the heading of 'Other Non-Current Assets' and amortised the same in the Statement of Profit and Loss based on the life of Agreement.

6. The querist has also informed that during the CAG audit for financial year (F.Y.) 2019-20, the CAG opined that the aforesaid treatment of way leave under the heading of 'Other Non-Current Assets' is incorrect as the Company gets a right to use of the underlying assets, and accordingly, the Company should reflect the same under the heading 'Right-to-Use Assets' in the Statement of Financial Position in accordance with Ind AS 116.

7. Thereafter, from 01<sup>st</sup> April 2020, based on discussion with CAG auditors and statutory auditors for the F.Y. 2019-20, the Company agreed to reclassify the said prepayments prospectively. Accordingly, the carrying amount of way leave prepayments as were reflected under the heading 'Other Non-Current Assets' were reclassified to 'Right-To-Use Assets' in the Statement of Financial Position in accordance with Ind AS 116.

8. *CAG Observation during accounts audit of F.Y. 2020-21*

During the accounts audit of F.Y. 2020-21, another team of CAG opined that the change in accounting treatment done by the Company is incorrect as *'the Company only has a right to lay the underground pipeline and not the actual land with it in its physical form'*. Accordingly, they advised the Company to reclassify such prepayments as 'Intangible Assets' under Ind AS 38.

9. Due to difference in opinions raised by different CAG teams, the Company assured CAG that it will seek an opinion from the Expert Advisory Committee (EAC) of the ICAI for the appropriate accounting treatment of aforementioned payments towards way leave charges and till the time the matter is decided by the EAC, the Company will treat such items as 'Right-To-Use Assets' as per the provisions of Ind AS 116.

## **B. Query**

10. On the basis of above, Opinion of the Expert Advisory Committee has been sought by the querist so as to determine the appropriate accounting treatment for classification of prepayments towards way leave charges, i.e., whether to:

- (i) account for such prepayments as 'Right-To-Use Asset' as per Ind AS 116; or
- (ii) account for such prepayments as 'Intangible Asset' under Ind AS 38; or
- (iii) account for such prepayments as 'Other Non-Current Asset'; or

- (iv) any other accounting treatment as EAC may consider appropriate in the case.

### C. Points considered by the Committee

11. The Committee notes that the basic issue raised by the querist relates to the classification of advance payment made towards way leave charges for laying city gas distribution network. The Committee has, therefore, considered only this issue and has not examined any other issue that may arise from the Facts of the Case, such as, detailed aspects of accounting for such advance payments, accounting for any other charges paid for laying city gas distribution network, determination of term of lease/right, appropriateness of accounting as per previous GAAP and before financial year 2020-21, accounting for any other assets (e.g. pipeline etc.), application of Ind AS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors', accounting in the books of Indian Railways (viz., the grantor of way leave facility), etc. Further, the Committee has expressed its opinion purely from the accounting perspective and not from the perspective of legal interpretation of Memorandum Agreement for permission of way leave facility etc. The Committee wishes to point out that the opinion expressed hereinafter is in the context of Indian Accounting Standards, notified by the Companies (Indian Accounting Standards) Rules, 2015 as amended from time to time.

12. With regard to the classification of payments for way leave, the first and foremost issue that needs to be examined is which standard should be considered and applied first. In this regard, the Committee notes that paragraph 9 of Ind AS 116, 'Leases' states, "At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. ...". From this, the Committee is of the view that the Company should first examine whether the contract in the extant case is or contains a lease as per the requirements of Ind AS 116. It is only when the contract in the extant case is not and does not contain a lease, the Company should consider the requirements of other Ind ASs including Ind AS 38, 'Intangible Assets'. In this regard, the Committee further notes that paragraphs 3 and 4 of Ind AS 116 provides the scope exceptions to the Standard as follows:

- "3 An entity shall apply this Standard to all leases, including leases of *right-of-use assets* in a *sublease*, except for:
- (a) leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
  - (b) leases of biological assets within the scope of Ind AS 41, *Agriculture*, held by a lessee;
  - (c) service concession arrangements within the scope of Appendix D, *Service Concession Arrangements*, of Ind AS 115, *Revenue from Contracts with Customer*;
  - (d) licences of intellectual property granted by a lessor within the scope of Ind AS 115, *Revenue from Contracts with Customers*; and
  - (e) rights held by a lessee under licensing agreements within the scope of Ind AS 38, *Intangible Assets*, for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights.
- 4 A lessee may, but is not required to, apply this Standard to leases of intangible assets other than those described in paragraph 3 (e)."

From the above, the Committee is of the view that none of the exceptions given in paragraph 3 (a) to (e) of Ind AS 116 are applicable in the extant case. The contract with the Railways in the extant case provides to the Company, rights to underground space wherein the gas pipelines are to be laid and such underground space is tangible. Therefore, the scope exclusion given under paragraph 4 of Ind AS 116 relating to rights to or lease of an intangible asset, is also not applicable. Accordingly, if the contract in the extant case is or contains a lease, the Company should apply the requirements of Ind AS 116.

13. In this context, the Committee notes the following clauses from Memorandum Agreement of terms and conditions for permission of way leave facility:

- “2. That no work shall be commenced or preceded without previous sanction and supervision of the concerned Railway Officers not below the rank of Divisional Engineer or any officer deputed by him. The grantee of way leave facility for laying of 1x762mm Ø U/G ms casing pipe for passing of 1x408mm Ø CNG carrier pipe near L-Xing No-4 SPL at KM 28/1-2 on GZB-SRE sec across Railway land shall be bound all the times at his own cost expenses and observe and carry out all rules and regulation which are already in force or which may there after be prescribed from time to time in future by the Govt. (Grantor). The grantee shall obey all such directions or orders of restrictions as may from time to time be given by said officers or his deputy duly authorized by him in relation to construction, lying down, deviation, shifting, stoppage, abandonment, alteration, repair or removal or with regard to time and manner of the work way leave facility for laying of 1X762mm Ø U/G MS casing pipe for passing of 1X406mm Ø CNG carrier pipe near L-Xing No-4 SPL at KM28/1-2 on GZB-SRE sec.
3. That it is distinctly understood by the grantee that the grantor shall retain the full legal title of ownership, right of access and inspection and have full control over the use and disposal of the Railway land for which temporary permission is given to the grantee only for the limited purpose of having laid down across the Railway land without conferring upon the grantee any right of possession or occupation of the land.”
- “8. That it is clearly understood by the party, the land is not licensed to the party for any of the purpose but only a permission granted in the form of way leave for a limited use of the land for way leave facility for laying of 1X762mm Ø U/G ms casing pipe for passing of 1X406mm Ø CNG carrier pipe near L-Xing No-4 SPL at KM 28/1-2 on GZB-SRE sec without conferring upon the party any right of possession or occupation of the land and without in any way affecting the Railway’s title, possession, Control, use of the land and right to enter upon etc. without any notice to the party.”
- “12. That the Railway administration may terminate this way leave permission at any time without assigning any reason and also without being held responsible to pay any compensation and on receipt of such notice, the party shall remove all crossing materials at its own cost and shall also make good any damage thereby occasioned to the surface or underground.”

“14. That the grantee shall not transfer in any way this way leave facility/right without prior approval of the Railway.”

“17. That the event of the Northern Railway desiring to execute new works, on Railway land necessitating the alteration or shifting of way leave facility for laying of 1x762mm Ø U/G ms casing pipe for passing of 1x406mm Ø CNG carrier pipe near L-Xing No-4 SPL at KM28/1-2 on GZB-SRE sec the grantee shall agree to carryout these alteration or shifting under the supervision of the said officer or the Northern Railway concern or his deputy or that he shall raise no objection to the work being done by the Railways or said officers at the cost of the grantee if in the opinion of the Railway such works are required to be done by the Railway. In either event, the grantee shall have no claim against the Govt. or Railway owing to interruption in the services.”

14. The Committee now examines whether the contract of right of way leave in the extant case can be considered as a ‘lease’ within the scope of Ind AS 116, ‘Leases’. In this context, the Committee notes the following paragraphs from Ind AS 116:

**“Lease** A contract, or part of a contract, that conveys the right to use an asset (the **underlying asset**) for a period of time in exchange for consideration.”

**“9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.”**

“B9 To assess whether a contract conveys the right to control the use of an identified asset (see paragraphs B13–B20) for a period of time, an entity shall assess whether, throughout the *period of use*, the customer has both of the following:

- (a) the right to obtain substantially all of the economic benefits from use of the identified asset (as described in paragraphs B21–B23); and
- (b) the right to direct the use of the identified asset (as described in paragraphs B24–B30).”

“B13 An asset is typically identified by being explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer.

B14 Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:

- (a) the supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting the asset and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time); and

- (b) the supplier would benefit economically from the exercise of its right to substitute the asset (ie the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).”

B15 If the supplier has a right or an obligation to substitute the asset only on or after either a particular date or the occurrence of a specified event, the supplier’s substitution right is not substantive because the supplier does not have the practical ability to substitute alternative assets throughout the period of use.”

*“Portions of assets*

B20 A capacity portion of an asset is an identified asset if it is physically distinct (for example, a floor of a building). A capacity or other portion of an asset that is not physically distinct (for example, a capacity portion of a fibre optic cable) is not an identified asset, unless it represents substantially all of the capacity of the asset and thereby provides the customer with the right to obtain substantially all of the economic benefits from use of the asset.

**Right to obtain economic benefits from use**

B21 To control the use of an identified asset, a customer is required to have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use (for example, by having exclusive use of the asset throughout that period). A customer can obtain economic benefits from use of an asset directly or indirectly in many ways, such as by using, holding or sub-leasing the asset. The economic benefits from use of an asset include its primary output and by-products (including potential cash flows derived from these items), and other economic benefits from using the asset that could be realised from a commercial transaction with a third party.

B22 When assessing the right to obtain substantially all of the economic benefits from use of an asset, an entity shall consider the economic benefits that result from use of the asset within the defined scope of a customer’s right to use the asset (see paragraph B30). For example:

- (a) if a contract limits the use of a motor vehicle to only one particular territory during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle within that territory, and not beyond.
- (b) if a contract specifies that a customer can drive a motor vehicle only up to a particular number of miles during the period of use, an entity shall consider only the economic benefits from use of the motor vehicle for the permitted mileage, and not beyond.”

**“Right to direct the use**

B24 A customer has the right to direct the use of an identified asset throughout the period of use only if either:

- (a) the customer has the right to direct how and for what purpose the asset is used throughout the period of use (as described in paragraphs B25–B30); or
- (b) the relevant decisions about how and for what purpose the asset is used are predetermined and:
  - (i) the customer has the right to operate the asset (or to direct others to operate the asset in a manner that it determines) throughout the period of use, without the supplier having the right to change those operating instructions; or
  - (ii) the customer designed the asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

*How and for what purpose the asset is used*

B25 A customer has the right to direct how and for what purpose the asset is used if, within the scope of its right of use defined in the contract, it can change how and for what purpose the asset is used throughout the period of use. In making this assessment, an entity considers the decision-making rights that are most relevant to changing how and for what purpose the asset is used throughout the period of use. Decision making rights are relevant when they affect the economic benefits to be derived from use. The decision-making rights that are most relevant are likely to be different for different contracts, depending on the nature of the asset and the terms and conditions of the contract.”

**“Protective rights**

B30 A contract may include terms and conditions designed to protect the supplier’s interest in the asset or other assets, to protect its personnel, or to ensure the supplier’s compliance with laws or regulations. These are examples of protective rights. For example, a contract may (i) specify the maximum amount of use of an asset or limit where or when the customer can use the asset, (ii) require a customer to follow particular operating practices, or (iii) require a customer to inform the supplier of changes in how an asset will be used. Protective rights typically define the scope of the customer’s right of use but do not, in isolation, prevent the customer from having the right to direct the use of an asset.”

From the above, the Committee notes that a contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Further, to assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has the (i) right to obtain substantially all of the economic benefits from use of the identified asset and (ii) right to direct the use of the identified asset.

In the extant case, the permission to use underground space is explicitly specified in the contract/agreement along with the specific dimensions (path, width, etc.) and is physically distinct from the remainder of the land (eg, area on the surface of the land). *Thus, an identified asset exists in the extant case.*

Further, the Committee notes that as per paragraph B14, even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if (a) the supplier has the practical ability to substitute alternative assets throughout the period of use; and (b) the supplier would benefit economically from the exercise of its right to substitute the asset. In this regard, the Committee notes that clause 17 of the Memorandum Agreement provides that "in the event of the Northern Railway desiring to execute new works on Railway land necessitating the alteration or shifting of way leave facility, the grantee shall agree to carry out alteration or shifting facility at its own cost". This clause seems to suggest that the Railways has substitution rights in case of Northern Railway executing new works on Railway land which necessitate alteration/shifting of the way leave facility. However, in this regard, the Committee also notes paragraph BC114 of Basis for Conclusions to International Financial Reporting Standard (IFRS) 16, 'Leases', issued by the International Accounting Standards Board (IASB), which *inter alia* provides as follows:

"... Some substitution rights are not substantive because the contract restricts when a supplier can substitute the asset. For example, if a contract states that a supplier can substitute the asset only on a specified future date or after the occurrence of a specified event, that substitution right is not substantive because it does not give the supplier the practical ability to substitute the asset throughout the period of use. ... "

From the above, the Committee is of the view that since in the extant case, the Railways has the right of substitution only on the occurrence of a specified event in future (viz., Northern Railway executing new works), substitution right is not substantive because it does not give the supplier the practical ability to substitute the asset throughout the period of use. Thus, as per the requirements of paragraph B15, *the supplier does not have the substantive right to substitute the asset throughout the period of use in the extant case.*

With regard to right to obtain substantially all the economic benefits from use of the identified asset throughout the period of use, the Committee notes that paragraph B21 of Ind AS 116 specifies that a customer can have that right, for example, by having exclusive use of the identified asset throughout the period of use. In this regard, the Committee notes that in the extant case, the Company has exclusive right to use the specified underground space throughout the period of use (although within the defined scope of its right to use the underground space) and therefore, *the Company has the right to obtain substantially all of the economic benefits from the use of identified asset.*

With regard to right to direct the use of the asset, the Committee notes that paragraph B24 of Ind AS 116 specifically provides that where the relevant decisions about how and for what purpose the asset is used are predetermined (as in the extant case, how and for what purpose the specified underground space will be used is pre-determined), an entity has the right to direct the use of an identified asset throughout the period of use only if it has the right to operate the asset or if it designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use. In this regard, the Committee notes from the Memorandum Agreement that the Company has the right to operate the specified underground space by having the right to lay down the pipelines, to inspect, repair and maintain them. The Company can make all the decisions about the use of the specified underground space although within the defined scope of the contract/agreement. Therefore, the Committee is of the view that in the extant case, *the Company has the right to direct the use of identified asset throughout the period of use.*

The Committee also notes that there are various clauses in the 'Memorandum Agreement' which provides some rights to the Railways in relation to the underground space in the extant case, for instance, right of access and inspection, etc. The Committee, considering paragraph B30 of Ind AS 116 is of the view that these are in the nature of protective rights to protect the Railways' interest in the asset, to protect its personnel or to ensure compliance with laws or regulations. These clauses define the scope of the customer's right of use but do not, in isolation, prevent the customer, viz. (the Company) from having the right to direct the use of an asset.

Therefore, the Committee is of the view that the arrangement in the extant case contains lease and the prepayments made towards way leave charge should be accounted for as per the requirements of Ind AS 116. As the arrangement contains lease, the question of applying other standards, for example, Ind AS 38 does not arise.

#### **D. Opinion**

15. In view of the above, the Committee is of the following opinion on issues raised in paragraph 10 above:

- (i) The arrangement in the extant case contains lease as discussed in paragraph 14 above. Thus, the prepayments made towards way leave charges should be accounted for as 'right-of-use' asset per the requirements of Ind AS 116.
- (ii) As the arrangement contains lease, the question of applying other standards does not arise. Therefore, Ind AS 38, 'Intangible Assets' is not applicable in the extant case.
- (iii) & (iv) In view of (i) above, answers to these questions do not arise.

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